Statement of
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For
Policy, Federal Deposit Insurance Corporation
On
Too Big to Fail
The Role of Bankruptcy and Antitrust Law In
Financial Regulation Reform
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And
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Chairman Cohen, Ranking Member Franks and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on issues relating to the failure of systemically important financial firms. My testimony addresses the role that a new resolution process for potentially systemically significant financial institutions can play in a set of integrated reforms designed to reduce the likelihood of any future financial crisis.

The current crisis has caused tremendous hardships for millions of Americans and shaken confidence in our institutions and financial system. Our system has proven resilient, but at great cost. We believe that targeted reforms can greatly improve the strength of the financial and regulatory system, while ending the possibility of future taxpayer bail-outs. These reforms should include strengthened oversight of our largest and most interconnected financial institutions, an oversight Council to identify and address emerging systemic risks, and tightened regulation of derivatives. However, improved supervision and regulation cannot prevent the next crisis. Fundamentally, we must end "too big to fail" as an approach for dealing with the largest financial firms in a crisis.

A fundamental problem has been the lack of a credible resolution mechanism for the largest financial firms, such as large bank holding companies, that addresses the need for speed, predictability, and continuity to avoid a disorderly collapse. Integrated with a proposed financial services oversight Council, this resolution mechanism would only apply when the Council determined that it was essential to protect against a systemic risk during a crisis in our financial system. While our antitrust and bankruptcy laws will continue to play a key role in ensuring robust competition in our free economy, a new resolution mechanism for the largest financial firms is essential.

There are fundamental differences between our largest financial firms and commercial or industrial companies. Large financial firms fulfill critical functions in providing financing for businesses and individuals, settling cash payments, intermediating liquidity and access to the capital markets and even providing the infrastructure and financing for the government securities market. The functioning of our markets depends on ready liquidity, confidence among market participants, and financial assets whose value is tied to the intermediation of market, credit, and other risks. To end "too big to fail" we must have a resolution process that can be applied in a crisis to protect the public interest, ensure that shareholders and other creditors absorb the risks and losses, and prevent interruption in a firm's system-critical financial operations. This is no bail-out – in fact, the resolution process we recommend would prohibit any special assistance targeted to specific open institutions.

The Problem of Too Big or Too Connected to Fail

As the current crisis abates, a key issue that must be addressed is how to end government bail-outs for financial firms considered too big or too interconnected to fail. In our current system, large systemically important financial firms (those the market believes are "too big to fail") are able to raise huge amounts of debt and equity and are given access to the credit markets at favorable terms without adequate consideration of the firms' risk profile. In turn, they leverage these funds and become even larger. This process makes investors and creditors ever more complacent and even more likely to extend credit without fear of losses. In some respects, investors, creditors, and the firms themselves are making a bet that they are immune from the risks of failure and loss. They believe, and have been proven correct so far, that the government will not allow these firms to fail for fear of repercussions on the broader market and economy.

In order to end too big to fail, we must find ways to impose greater market discipline, while avoiding the potential damage to our financial system that would result from a disorderly collapse of one of these firms in a crisis. We must provide a resolution process that instills confidence, both in the market and with policymakers, that closing these institutions will not lead to a systemic collapse. The solution must provide, first and foremost, a legal mechanism for the orderly resolution of these institutions similar to that which exists for FDIC-insured banks. This solution should ban assistance to specific open institutions to avoid any future bail-outs of these firms. The goal is to stop bail-outs and, thereby, enhance market discipline, while permitting the swift and orderly dissolution of the firm and the absorption of its assets by the private sector as quickly as possible.

The ad-hoc response to the current banking crisis was inevitable because no playbook existed for taking over an entire complex financial organization. The disruptions that occurred in the aftermath of the Lehman Brothers bankruptcy filing, including illiquidity in major credit markets, made market participants and policymakers wary of using the bankruptcy process for major financial holding companies or financial firms. Bankruptcy can create dangerous uncertainty about the resolution of a systemically significant financial firm because the process entails negotiated solutions that, as in the Lehman bankruptcy, may leave hundreds of thousands of contracts unresolved for months. While the bankruptcy process works well for the vast majority of commercial insolvencies, it can engender broad disarray in the markets if the debtor's financial interconnections extend throughout the credit, derivatives, and other financial markets around the globe. Following the Lehman Brothers filing, the commercial paper market stopped functioning and the resulting decrease in liquidity threatened other financial institutions and businesses.

One explanation for the freeze in markets was that the Lehman failure shocked investors. Following Bear Stearns, investors assumed Lehman was too big to fail and its creditors would garner government support. Simply put, because investors did not consider that there was a possibility that Lehman would file for bankruptcy protection, investors were willing to make "moral hazard" investments in the high-yielding commercial paper of large systemic institutions.

Another explanation is that the bankruptcy process was not designed to achieve the level of certainty needed for financial firms, like Lehman. In such firms, the value of the business and its assets are dependent on its relationships with other market participants. Those relationships, in turn, depend on financial market contracts that require immediate and continuous access to vast quantities of liquidity. Rumors about Lehman's liquidity problems, and the subsequent bankruptcy filing, triggered asset fire sales and destroyed the liquidity of a large numbers of claims held by Lehman's direct counterparties as well as of claims held by counterparties several steps removed from those having claims directly against Lehman itself. This led to an abrupt collapse of liquidity as the ability of parties throughout the market to complete settlements was placed into doubt.

While the underlying causes of the market disruption that followed the Lehman failure will be debated for years to come, both explanations point to the need for a new resolutions scheme for systemically important non-bank financial institutions which will provide clear, consistent rules for closing and resolving systemically important financial institutions, as well as a mechanism to maintain key systemic functions during an orderly wind down of those institutions.

Under both explanations, we are left with the same conclusion – we must have a resolution mechanism designed to deal with a small, but critical, subset of complex financial firms. This is essential so that regulators can end "too big to fail" while avoiding the financial disruptions that could devastate our financial markets and economy. We must ensure that this process is effective so that the U.S. taxpayer will never again be called upon to prop up failed financial firms. Had a credible resolution mechanism been in place to resolve financial entities like Lehman prior to its bankruptcy filing, investors would have paid the price of betting on a government rescue. Market liquidity would have been maintained and markets would not have reacted so negatively to the shock of a failure because they would be assured of an orderly and efficient wind down process.

The Role of Bankruptcy

Bankruptcy has a long and honored history under U.S. law. For the vast majority of the business bankruptcies in the United States, the current system has worked very well. In fact, the U.S. bankruptcy process is aptly considered a strength of our commercial and economic system. Many thousands of businesses have been successfully reorganized or liquidated under the Bankruptcy Code for the benefit of the creditors of that enterprise. The bankruptcy process has even been an effective tool for restructuring large companies such as General Motors and Chrysler.

However, experience has shown that it does not work well for the largest financial companies where their inability to complete settlements, or access liquidity, can trigger widespread market uncertainty. There are four key reasons for adopting a new resolution process for our largest financial firms. First, protection of the public interest must be paramount in designing an insolvency process for firms whose failure could, if not properly handled, trigger broader disruptions in our economy. The bankruptcy process focuses on resolving creditor claims and not protection of the broader public interest. For almost all insolvencies, this is the appropriate focus, but not for our most complex financial firms. Under the proposed resolution process for systemically significant financial firms, creditors would not determine the shape of the resolution, incumbent management would be replaced, and the resolution would be designed to protect the public, while ensuring that shareholders and other responsible parties bore the losses first. That is, the parties responsible for taking on the risks that destroyed the firm would be made to pay the price for their decisions, not the taxpayers.

Second, a resolution of these financial firms requires pre-planning and cannot depend on administration by a debtor in possession, a newly appointed trustee, or a creditors' committee. An essential element in the FDIC's process for resolving failed insured banks virtually overnight is extensive pre-planning of the resolution and the ability to develop expertise in quickly implementing a resolution that preserves critical financial operations once the bank is closed. In fact, without the ability to pre-plan for the closure of an insured bank, the FDIC could not achieve success in giving insured depositors virtually immediate access to their deposits. This factor, so critical to preserving liquidity for even the smallest failed bank, is self-evidently indispensible to avoid broader market and economic disarray in the resolution of the largest financial firms in a crisis. While the bankruptcy process works effectively for reorganizing or winding up commercial firms, it is critical that an intervention into the innumerable financial connections of a major financial firm be well-planned in advance. Since these firms, in the past, have tended to fail abruptly due to a liquidity collapse, pre-planning and the ability to act quickly and efficiently is vital.

Third, a resolution of the most complex financial firms must be implemented quickly and in a predictable way. A resolution process using a governmental receiver that has developed expertise in the financial operations of large firms can provide the certainty needed by the financial markets. It is essential that the receiver have the power to act quickly and decisively to take over the business, preserve systemically significant financial operations, establish a bridge institution, and provide continuity for those critical operations. A governmental receiver can provide certainty by issuing regulations or statements of policy addressing key issues. Speed and predictability allows the markets, both domestic and international, to make investment, pricing and liquidity decisions with greater certainty and reduces the likelihood of market disruptions. The uncertainty about the settlement of hundreds of thousands of financial market contracts following Lehman's bankruptcy filing last fall substantially contributed to the ensuing liquidity crisis as investors and other market participants drew back from exposures in the market.

Fourth, a resolution process must provide continuity to critical financial functions. We have recommended that a special resolution process for systemically significant financial firms include an option to create a bridge financial institution. This tool, which is available as well in bank receiverships, allows the receiver to transfer assets and contracts from the failed firm to the bridge institution in order to retain franchise value and to avoid dumping financial contracts on the markets. Under the proposed resolution process, financial market contracts could be transferred to the bridge institution run by the governmental receiver without triggering netting and liquidation rights. This could prove vital to avoid a market melt-down.1 The bridge financial institution also can maintain other systemically significant functions such as payments processing, securities lending, and the settlement of ongoing government securities or other transactions. Most critically, the bridge financial institution allows time to avoid a sudden loss of critical services and promotes market confidence.

The bridge financial institution option, and the continuity it can provide, requires access to liquidity for ongoing operations. To achieve this, the proposed special resolution process includes ready access to liquidity for the bridge financial institution from a resolution fund provided from assessments paid by the industry. In contrast, under the Bankruptcy Code, a Chapter 11 debtor who will incur post-petition expenses to maintain operations must often borrow from lenders, usually at unfavorable rates. Debtor in possession financing can be particularly costly, or unavailable, for large financial firms in bankruptcy since their assets are so dependent on market liquidity and confidence and the bankruptcy filing itself greatly reduces their asset value. The result is that there may be less funding to preserve valuable ongoing operations for sale. According to some commentators, the lack of debtor in possession financing following the Lehman bankruptcy filing led to many possible Chapter 11 reorganizations becoming Chapter 7 liquidations. Under the proposed resolution system for systemically significant financial firms, the bridge option with its access to liquidity will provide continuity, while better preserving the value of financial assets for the benefit of creditors.

The FDIC's current authority for insured banks and thrifts to act as receiver and to establish a bridge bank to maintain key functions and sell assets offers a good model. A temporary bridge bank allows the FDIC to transfer needed contracts to the bridge bank and preserve key banking operations, which can be crucial to stemming contagion. At the same time, by closing the bank and placing it into receivership, the FDIC assesses the losses against shareholders and market participants who should appropriately bear the risk. By preserving the going concern value of the financial assets, it also encourages interest by other firms in purchasing the operations and assets of the firm, which can reduce losses to the receivership.

Addressing Special Risks Posed By the Derivatives Markets

One of the major risks demonstrated in the current crisis is the tremendous expansion in the size, concentration, and complexity of the derivatives markets. While these markets perform important risk mitigation functions, financial firms that rely on market funding can see it dry up overnight. If the market decides the firm is weakening, other market participants can demand more and more collateral to protect their claims. At some point, the firm cannot meet these additional demands and it collapses. Under both the Bankruptcy Code and bank insolvency law, the counterparties to insolvent firms can terminate and net out derivatives and sell any pledged collateral to pay off the resulting net claim. During periods of market instability -- such as during the fall of 2008 -- the exercise of these netting and collateral rights can increase systemic risks. At such times, the resulting fire sale of collateral can depress prices, freeze market liquidity as investors pull back, and create risks of collapse for many other firms.

In effect, financial firms are more prone to sudden market runs because of the cycle of increasing collateral demands before a firm fails and collateral dumping after it fails. Their counterparties have every interest to demand more collateral and sell it as quickly as possible before market prices decline. This can become a self-fulfilling prophecy -- and mimics the depositor runs of the past.

However, a significant difference between the Bankruptcy Code and bank insolvency law, as contained in the Federal Deposit Insurance Act (FDIA), allows the FDIC to address these risks in a bank failure and should be incorporated into the proposed resolution system for systemically significant financial firms. The difference is that under the FDIA, the counterparties to derivatives – called Qualified Financial Contracts in the FDIA - with a failed bank in receivership cannot terminate and net their contracts until after 5 p.m. on the business day following appointment of the FDIC as receiver. During this "window," the FDIC can repudiate the contracts and pay more limited damages, or it can transfer the derivatives intact to another bank or to an FDIC-operated bridge bank. This power is critical to providing continuity to financial operations as well as to preserving value in derivatives to the benefit of the bank's creditors. It also illustrates the important interplay between different recommended insolvency powers - such as those to create bridge banks and transfer derivatives - needed to deal with the rapidly changing conditions affecting large financial institutions.

Other Powers Needed by a New Resolutions Entity

There are other resolution powers that are important to an effective resolution process for systemically significant financial firms. For example, the new resolution entity should be independent of the firm's prudential supervisor. In creating a new resolution regime, we must clearly define roles and responsibilities and guard against creating new conflicts of interest. No single entity should be able to make the determination to resolve a systemically important institution – there should be procedural and oversight checks and balances. For example, the current statute requires that decisions to exercise the systemic risk authorities for insured depository institutions must have the concurrence of several parties.2 For this reason, we have recommended that the oversight Council have the power to decide that the resolution of a systemically significant financial firm poses such a great risk to the public and financial system that it should be resolved through this new process, and not under the Bankruptcy Code. The Council would define why it chose to act, report to Congress on its action, and appoint the statutory receiver for the insolvent firm. The checks and balances in this process, as well as the right of shareholders to challenge the closing in court, prevent precipitous action and preserve market expectations.

Once the decision to resolve a systemically important institution is made, the resolution entity must have the flexibility to implement this decision in a way that protects the public interest and limits costs. This flexibility in implementing the resolution is critical because there will be many complex decisions to be made, even under a well-developed statutory and regulatory framework, to quickly take over one of the largest financial firms and ensure that it can continue to operate critical payments and other financial functions. However, this flexibility is not unlimited and the receiver would remain liable for damages in an action in federal court should it deny a valid claim by a creditor.

As receiver for failed insured banks and thrifts, the FDIC has the authority to terminate contracts after the failure, including contracts with senior management whose services are no longer required. Through its repudiation powers, as well as enforcement powers, termination of such management contracts can often be accomplished at little cost to the FDIC. Moreover, when the FDIC establishes a bridge institution, it is able to contract with individuals to serve in senior management positions at the bridge institution subject to the oversight of the FDIC. The new resolution entity should be granted similar statutory authority as in the current resolution of financial institutions.

These additional powers would enable the resolution authority to employ what many have referred to as a "good bank -- bad bank" model in resolving failed systemically significant institutions. Under this scenario, the resolution authority would take over the troubled firm, imposing losses on stockholders and unsecured creditors. Viable portions of the firm would be placed in the good bank, using a structure similar to the FDIC's bridge bank authority. The nonviable or troubled portions of the firms would remain behind in a bad bank and would be unwound or sold over time. Even in the case of creditor claims transferred to the bad bank, these claims could be made partially liquid very quickly using a system of "haircuts" tied to FDIC estimates of potential losses on the disposition of assets.

The proposed resolution system will not upset settled commercial or creditor expectations. Creditors will receive payment according to a statutory priority system - virtually identical to that found in the Bankruptcy Code. Likewise, lien and other contract rights, as in FDIC receiverships, will have specific statutory protection. Like the current FDIC receivership process for failed insured banks, the proposed insolvency mechanism for systemically significant financial firms would provide for resolution of claims through an administrative claims process followed by de novo access to the federal courts for shareholders and creditors of the firm. In short, the proposed resolution system addresses how to protect the public interest, while preserving the rights of creditors.

Who Should Resolve Systemically Significant Entities?

As the only government entity regularly involved in the resolution of financial institutions, the FDIC can testify to what a difficult and contentious business it is. Resolution work involves making hard choices between competing interests with very few good options. It can be delicate work and requires special expertise.

In deciding whether to create a new government entity to resolve systemically important institutions, Congress should recognize that it would be difficult to maintain an expert and motivated workforce when there could be decades between systemic events. The FDIC experienced a similar challenge in the period before the recent crisis when very few banks failed during the years prior to the current crisis. While no existing government agency, including the FDIC, has experience with resolving the largest systemically significant financial firms, probably no agency other than the FDIC currently has the kinds of skill sets necessary to perform resolution activities of this nature.

In determining how to resolve systemically important institutions, Congress should only designate one entity to perform this role. Assigning resolution responsibilities to multiple regulators creates the potential for inconsistent resolution results and arbitrage. While the resolution entity should draw from the expertise and consult closely with other primary regulators, spreading the responsibility beyond a single entity would create inefficiencies in the resolution process. In addition, establishing multiple resolution entities would create significant practical difficulties in the effective administration of an industry funded resolution fund designed to protect taxpayers.

Conclusion

The evidence from this financial crisis demonstrates the need for changes in the way the failures of systemically important financial firms are handled. The failure of a systemically important financial firm can be devastating to financial markets, businesses, and all Americans. It is essential that we put an end to "too big to fail" by imposing greater market discipline on systemically important institutions. The FDIC believes that the solution must involve, first and foremost, a legal mechanism for the swift and orderly resolution of systemically important financial firms in a crisis and that the FDIC's resolution powers as the receiver of failed insured depository institutions provide a good model.

The FDIC stands ready to work with Congress on this critical issue.

1 Professor Jay Westbrook noted in his testimony before the Subcommittee on Sept. 26, 2008, that the exemption of financial assets from bankruptcy proceedings poses difficulties in implementing a comprehensive process for creditors. While we agree that parties to financial contracts should retain some "skin in the game," an equally important part of the problem is that these contracts rapidly lose value if they are tied up in insolvency proceedings. To retain their value for creditors and to mitigate market disruptions if they are immediately liquidated, the bridge institution option allows the receiver to avoid immediate netting and liquidation, continue the contracts, and minimize the potential for spreading disruptions in the financial markets.

2 The FDI Act permits the FDIC to take action or provide assistance as necessary to avoid or mitigate the effects of a perceived systemic risk. In order for this to occur, the Act requires that there be a finding of systemic risk by the FDIC's Board of Directors, concurrence of the Board of Governors of the Federal Reserve System and a subsequent determination of systemic risk by the Secretary of the Treasury, following consultation with the President.

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